2 Transaction costs

To new institutional economics (NIE) contributors, transactions are the basic unit of analysis in economics (Williamson, 1985a: 18). Why so? Because they view economics as primarily concerned with the transfers of rights to use goods and services for production and exchange, transfers that are central for benefitting from the division of labor and specialization (Coase, 1998). In that respect, the NIE approach differs profoundly from the neoclassical perspective: NIE looks at economics through the lens of the transfer of rights to use a resource; the neoclassical paradigm looks at economics through the lens of trade in goods and services on markets.

The NIE approach has substantial consequences. At the micro-level, it means focusing on how economic activities are actually organized in response to transaction costs. At the macro-level, it means focusing on how institutional and organizational structures affect performance, development, and growth. This chapter briefly presents the central concepts of transaction and transaction costs (2.1), the origin and misinterpretations of the "Coase theorem" (2.2), and the implementation as well as the extension of the transaction costs approach (2.3). Examples of the application of transaction costs analysis at the micro- and macro-level are developed in Parts II and III of this book.

2.1 Core concepts: from transactions to transaction costs

The concept of transaction is tightly intertwined with the idea that organizing transactions involves costs. We introduce first the NIE definition of transaction and then that of transaction costs, and follow with some important consequences of this transactional approach.

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2.1.1 Transactions

Transactions broadly defined are the transfer of rights to use a resource. All transactions involve at least two parties, which explains why a substantial part of the literature on transactions has focused on bargaining and contracts (see Chapter 4). When I rent a car to go out of town for the weekend, I acquire from the owner of the car (the rental company, which might well be the subsidiary of another company) the right to use this car under certain conditions. For example, I must commit to assume certain liabilities and to return the car in an appropriate condition as specified in the rental contract.

This example shows how the concept of transaction overlaps with that of property rights, with these rights defined as "the rights of individuals to the use of resources" (Alchian, 1965: 817; more on this concept in Chapter 3). The right to use is seldom limitless; it is usually constrained by restrictions specified in a transactional agreement or imposed by external rules. For example, a requirement to get the rented car insured might be imposed by the rental car company or made compulsory by the law. In that respect, transactions usually allow only limited use of a good or service since they are deeply embedded in institutions delineating the domain of acceptable usage. In the car rental example, the contract is embedded in contract law and my usage of the car is constrained by traffic regulation. It also means that economic rights are intertwined with legal rights (Cheung, 1969b). Insurance might be compulsory, but its coverage may vary, which translates into variations in cost.

Besides institutional embeddedness, for a transaction to happen the good or service to be traded must be technologically separable from other goods and services. This requirement explains why a transaction is frequently described as occurring "when a good or service is transferred across a technologically separable interface" (Williamson, 1985a: 1). For example, melting iron is a continuous process that cannot be segmented, while transportation of iron slates can be separated from the melting operation. This seems a simple idea but it has important implications. As soon as separability is technologically possible, the question becomes how to organize the process at stake. The economics of organization then emerge as a core component of the transactional approach (see Chapter 5) and technological considerations are integral to that approach. Indeed, technology and organization are tightly intertwined, with technology constantly changing what is tradeable and how. For example, technologi-

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cal developments have increasingly allowed unbundling the parts of a cell phone so that they can be produced and assembled in places around the world, while it has also bundled previously separate functions so that the purchase of a cell phone now buys a camera, a calculator, a calendar, and so on.

Hence, for a transaction to exist requires (1) the transfer of rights among parties, (2) the usage of these rights under constraints that might be specified within the transactional agreement and/or by external rules, and (3) goods or services that are technologically separable. Thus understood, transactions are not limited to transfers of rights on markets; non-market transactions are continuously conducted within firms as well as among a variety of other organizational arrangements, such as public bureaus, franchising, strategic alliances, cooperatives, and the like.

2.1.2 Transaction costs

Every transaction is exposed to "transactional failures" (Williamson, 1971). To be consummated, a transaction requires technological and institutional supports that entail costs. On the technological side, from the Code of Hammurabi engraved in stone to modern contracts, parties to a transaction need the means to communicate. This is true even for an agreement based on a handshake, since even that requires the use of language, which entails the cost of learning a common language. On the institutional side, the transfer of rights may occur through different organizational arrangements, with markets being only one solution among a set of alternatives (see Chapter 5). Whatever the arrangement chosen, any transfer of rights incurs the cost of delineating and policing those rights, a necessary condition for transacting parties to commit.

Once the existence of transaction costs is acknowledged, the next question is: what are the causes and sources of transaction costs? Coase pioneered the investigation of that question in two highly influential articles. In "The nature of the firm" (1937), he raised what became a central issue in economics: if markets are efficient, why are there firms? His answer emphasizes the comparative costs of using the price mechanism versus the costs of organizing transactions through management. In the "Problem of social cost" (1960), Coase pointed out the key components of market transactions, stating that: "In order to carry out a market transaction it is necessary to discover who it is that one wishes to deal with,

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to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on" (1960: 15). Dahlman (1979: 148) translated these requirements into an often quoted statement identifying transaction costs as the combination of "search and information costs, bargaining and decision costs, policing and enforcement costs" involved in the organization of market exchange.

These specifications tend to overemphasize the organization of transactions in the context of market exchanges, in which transaction costs are "the cost of using the price mechanism" (Coase, 1937). Beyond Coase's initial insight, much less has been said about transactions carried out within the firm. What about the "managerial" or "administrative" costs involved in setting up, maintaining, and operating resources and their transfer across technologically separable interfaces within the firm (Furubotn and Richter, 1997: 44 sq.) or, for that matter, within alternative organizational solutions, for example within strategic alliances? Coase already provides some guidance, pointing out the need to comparatively assess the costs of transfers through markets versus in-house, stating that "a firm will tend to expand until the costs of organizing an extra transaction within the firm become equal to the costs of carrying out the same transaction by means of an exchange on the open market or the costs of organizing in another firm" (Coase, 1937: 395). Cheung (1969b), a disciple of Coase, went a step further in showing the relevance of the transactional approach to understand the variety of modalities through which parties can organize transactions, thus facing complex tradeoffs. Using Chinese data on sharecropping, he pointed out "the presence of a variety of contractual arrangements under the *same* constraint of competition" and the role of transaction costs in opting for a specific arrangement.[1]

The idea that transaction costs encompass far more than the costs of market exchanges led scholars to reconsider and extend the concept of transaction costs to capture the diversity of arrangements through which transactions can be organized. Based on a more encompassing definition of transaction costs, Allen (1991: 3; 2000) contrasted the narrow approach

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[1] In the same article, Cheung argues that transaction costs differ because physical attributes, institutional factors, and modalities of negotiation and enforcement differ.

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favored by neoclassical economics, which identifies transactions and their costs solely as the trading of goods and services through markets, thus identifying them as equivalent to taxes, with the new institutionalist approach, which considers transactions costs as the resources used to establish, transfer, and maintain property rights (see Box 2.1). Further, transaction costs vary according to the choice of organizational modalities (or "governance structure"[2]) chosen to carry out the transaction as well as with the institutional conditions framing these rights and their transfer (see also Alston et al., 2018: 68).[3]

Box 2.1 Neoclassical vs NIE approach to transaction costs: Robinson Crusoe and Friday

In an article that helped clarify the concept of transaction costs, Allen (2000; 895 sq.) criticized neoclassical economics (e.g., Niehans, 1987) for its narrow definition of transaction costs as the result of frictions in trading activities, frictions typically caused by information asymmetries, transportation costs, taxes. With this definition, transactions costs can be introduced into a standard equilibrium model to reach a first best solution.

However, as Allen pointed out, defining transaction costs as information or transportation costs is inadequate. Consider Robinson Crusoe, shipwrecked on his island, alone before the arrival of Friday. He faced information and transportation costs, even though there was no transacting going on!

In the broader concept prevailing in the new institutional approach, transaction costs encompass the multidimensional components that contribute to the establishment, allocation, and monitoring of rights to use a resource. For example, Cheung (1989: 77) defines transaction costs as "a spectrum of institutional costs including those of information, of negotiation, of drawing up and enforcing contracts, of delineating and policing property rights, of monitoring performance, and

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[2] Williamson defines "governance structure" as "the institutional matrix within which transactions are negotiated and executed" (1979: 239; also 1996: 378).

[3] Medema (2020: 1068 sq.) provides extensive indications on the different approaches to transaction costs.

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of changing institutional arrangements." These costs do not exist in the solitary world of Robinson Crusoe. They emerge with the arrival of Friday, when arrangements must be made to organize the use of the scarce resources available. We enter into a world of alternative organizational solutions, each of which has different costs that must be assessed comparatively. Welcome to the world of second-best![4]

2.1.3 Consequences

One of the profound consequences of the property rights interpretation of transaction costs is that it reinforces that there are alternative ways to allocate these rights and to organize their transactions so that decision-makers face tradeoffs. Although it mainly focuses on the costs of market transactions and the role of the definition and allocation of property rights in overcoming externalities, "The problem of social costs" (Coase, 1960) already emphasized the need to consider and compare alternative solutions to the allocation of rights.[5] However, Coase's contribution was largely intuitive. A full-fledged theory of transaction costs was still needed to illuminate the transactional logic behind the tradeoff among different organizational solutions and the role played by institutions in shaping the organization and achievement of transactions.

This unfinished business attracted the attention of Williamson. Dissatisfied with existing theories of vertical integration which he confronted while working at the US Department of Justice and which mostly assumed that businesses merge in order to dominate markets through monopoly power,[6] he turned to Coasian transaction costs as an explanation.[7] A crucial point made by Coase (1937: 389) was that "It is surely important to enquire why coordination is the work of the price mech-

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[4] As well summarized by Medema (2020: 1051): "in the real world of positive transaction costs, all coordination mechanisms – markets, firms, and government – are costly and imperfect, meaning that there is no route to the optimum."

[5] In his conclusion, Coase stated: "Furthermore we have to take into account the costs involved in operating the various social arrangements (whether it be the working of a market or of a government department), as well as the costs involved in moving to a new system" (1960: 44).

[6] Coase (1972 [1988]) made a similar point.

[7] Although Williamson paid tribute to Commons for having introduced the idea "that the transaction is the ultimate unit of microeconomic analysis"

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anisms in one case and of the entrepreneur in another …" Williamson (1975) adopted a micro-analytical approach to explain this tradeoff, which he reformulated as the choice between acquiring a needed good or service through markets (to "buy") or producing it within the organization (to "make"). He showed that understanding this "make-or-buy" tradeoff requires considering the "attributes" of the transaction at stake. The logic is straightforward: when competition pushes transactors to minimize costs, they must consider the characteristics of the transaction at stake (its attributes in Williamson's terminology) if they are to adopt the least costly organizational solution. The Williamsonian model (1975; 1985a), which has inspired thousands of empirical tests, focuses on three attributes, understood as "the principal dimensions with respect to which transactions differ" (Williamson, 1985b: 181): (1) the uncertainty surrounding a transaction (a point already made by Coase in 1937), (2) the specificity of the assets needed to make the transaction possible, and (3) the frequency with which the transaction happens. Our car rental example illustrates.

Uncertainty, leading to "unprogrammed adaptations" (Williamson, 1971: 113) may come from moral hazard (the misbehavior of the driver due to improper insurance or rental contracts) or adverse selection (the driver has been poorly trained). Specific investments by the car rental company include a fleet of cars and offices outposts for different parts of its service territory. And the frequency of rental agreements impacts the cost of monitoring these agreements. Chapter 5 provides more detail on the explosion of research on the theory of organization that followed this breakthrough, often identified as transaction cost economics (TCE), which led to the award of the Nobel Prize to Williamson in 2009.

2.2 The "Coase theorem": origin and misinterpretations

This prominent role of transactions and their costs did not percolate easily through economics. Paradoxically, and to the dismay of Coase and his followers, the initial and long predominant neoclassical interpreta-

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(1975: ix), his conception of transaction and transaction costs is definitely Coasian (see Chapter 1).

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tion of Coase's concept of transaction costs was stuck in what became the infamous "Coase theorem" and its radical assumption about "the strange world of costless transactions" (Furubotn and Richter, 1997: 8). Notwithstanding Coase's own view and the general agreement in NIE and beyond that transaction costs exist, are positive, and differ from production costs, a resilient view that focuses on the so-called 'Coase Theorem' and remains the source of disconcerting interpretations even today.[8]

Box 2.2 The origins of the "Coase theorem"

The Coase theorem, which enjoys such renown in economics, got its start over cocktails.

In 1959, Ronald Coase, then a professor at the University of Virginia, had just written "The Federal Communications Commission" (1959). In it, he argued controversially that the FCC should auction radio spectrum instead of assigning it by fiat, asserting that assignment by fiat raised the ugly possibility of political control over freedom of the press. Auctions would end that specter and allow private investors to trade their rights in order to maximize investment and productivity.

Coase contended that if rights were well defined and freely tradeable on perfectly competitive markets, it would not matter what the initial assignment of rights were, they would be negotiated and traded in ways that maximize the value of their usage. To a group of economists at the University of Chicago, this argument seemed like "heresy," so they invited Coase to Chicago to defend it. The subsequent discussion over drinks at the home of Aaron Director, then editor of the Journal of Law and Economics, included such luminaries as Milton Friedman, Arnold Harberger, and George Stigler. Stigler later described the meeting in his autobiography as an "eureka moment" (1988).

According to Stigler, at the beginning of the discussion, the assembled economists voted 20 to 1 against Coase; (Coase cast the only vote in his

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[8] For an extensive review and discussion of the literature on the Coase theorem, see Medema (2020). Medema also shows (in section 6) how the "Coase theorem" and its zero transaction costs assumption permeated almost all domains of economics and influenced numerous contributions in legal studies, political science, etc.

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favor). After much discussion, Coase prevailed and all 21 voted in his favor and asked him to write up his argument for the Journal of Law and Economics. That article became "The problem of social cost," one of the most cited articles in economics and law. Stigler coined the term "Coase theorem," which he described succinctly: "under perfect competition, private and social costs will be equal …" (1966: 113).

What Stigler's snapshot of the "Coase theorem" in Box 2.2 means is that "in the absence of transaction costs, the allocation of resources is independent of the distribution of property rights" (Allen, 2000: 897). Indeed, what Coase showed in "The problem of social cost" is that under the standard assumptions of economic theory – perfect competition, perfect information, frictionless bargaining, in other words, a world of zero transaction costs – rational actors can negotiate a bargain that allocates rights in a way that will maximize production, regardless of the initial assignment of those rights (Shirley, 2013: 244; Medema, 2020: 1072 sq.). In a world of costless transactions, as long as property rights are fully specified,[9] efficient outcomes will arise through transacting regardless of which party initially owns which right and which institutions organize transactions. The "Coase theorem" thus assumes that an efficient outcome can be reached without consideration for the way property rights are allocated and transferred.

Coase's 1960 article unambiguously argued that this standard economic assumption of zero transaction costs is unrealistic. As Coase later explained, "The world of zero transaction costs has often been described as a Coasian world. Nothing could be further from the truth. It is the world of modern economic theory, one which I was hoping to persuade economists to leave" (Coase, 1988b: 174). "The problem of social cost" and several other contributions by Coase were "contrasting a frictionless world with the real world of costly coordination" (Medema, 2020: 1061).

The distinction between a world of zero transaction costs and one with positive transaction costs is therefore fundamental, and key to understanding the opposition of NIE contributors to the standard neoclassical

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[9] Medema (2020: 1072) emphasizes the importance of two other underlying assumptions to the "theorem": utilities are transferable and information is costless.

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interpretation. In an article written for the Nobel Committee when it was considering awarding Coase the prize, Barzel and Kochin rightly asserted that "Coase's explicit separation of the zero and positive transaction cost models made economists aware of the need to spell out the transaction cost assumptions under which analysis is conducted … [G]iven that transaction is costly, whether it is carried out in the market or by government, Coase pointed out the need to compare outcomes of actions carried out under different institutional settings" (1992: 22).

Understanding Coase's argument and assessing its multiple consequences for our understanding of the variety of organizational arrangements and the role of institutions in framing our economies should be part of the core of economists' agendas. One might expect that economists reading "The problem of social cost" would have learned this lesson and rethink their assumption that institutions and transaction costs can be omitted from their models. Unfortunately, that did not happen. To the contrary, most economists incorrectly assumed that Coase believed that transaction costs were usually zero.[10] But for some few scholars, Coase's argument lit an intellectual fire that blazed into the new institutional economics in the mid-1970s.

2.3 Implementation and extension of the transaction cost approach

Ronald Coase was right when he stated (1972 [1988]: 63) that "The nature of the firm" was "an article much cited and little used" (1972 [1988]: 63). Yet, surprisingly it is this article, which focused on the reason why firms exist without an explicit reference to transaction costs, more than "The problem of social cost" which explicitly introduced transaction costs[11]

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[10] According to Shirley (2013), "A survey of 45 textbooks found that 80% of them misrepresented Coase's arguments (Butler and Garnett, 2003). Another, later survey of 40 of the most cited and most recent articles on the Coase Theorem concluded that 75% of them misrepresented Coase's viewpoint (Yalcintas 2010)."

[11] As noted by Williamson (1975: 3), Commons already introduced the idea of transaction as "the ultimate unit of economic investigation" (Commons, 1934: 4–8).

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that initially caught the attention of economists.[12] However, two leading figures changed this situation, giving an impulse to research built on the concept of transaction cost and initiating NIE as a powerful movement among economists and beyond.

We already mentioned the role of Oliver Williamson in that respect (see 2.1 above). Besides establishing transaction costs as critical to understanding industrial organization (1975; 1985a), he pointed out the role of this concept as central to a "comparative institutional approach to the study of economic organization" (1985a: 387), opening a rich stream of research that we detail in Chapter 5. Douglass North, the other leading figure at the origin of NIE, established transaction costs as a tool to understanding the economic role of institutions, as well as development and growth (North and Thomas 1973 [1999]; North 1981; 1990a), launching a new domain of research explored in Chapters 6 to 8. Williamson and North thus initiated a movement that describes the major impact that transactions and their associated costs have on our understanding of how human activities are organized and the role of institutions as a major determinant framing these costs. Subsequently, the concept has been extended to analyze numerous institutional dimensions. For example, Arrow early on defined transaction costs as "the cost of running the economic system" (1969: 48). More recently and in the same vein, Allen (2012: 19) described transaction costs as "those costs necessary to establish and maintain any system of rules and rights."

These extensions capture the idea that transactions are deeply embedded in institutions, making transaction costs an integral part of the institutional setting. One outcome of this broader point of view is the introduction of the concept of "political transaction costs" as distinct from economic transaction costs (see North, 1990b; also Dixit, 1996; Furubotn and Richter, 1997: 43 sq., Caballero and Arias, 2013; Caballero and Soto-Oñate, 2016). While economic transactions are trades in the right to use a resource, political transactions transfer the temporary right to exercise political authority (Moe, 1990; Caballero and Soto-Oñate, 2016). Economic transaction costs are the costs of organizing pro-

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[12] Medema (2020, section 4) extensively reviewed the highly critical reactions among leading economists to the concept of transaction costs following the publication of "The problem of social cost." Fisher (1977) synthesized this opposition qualifying the concept as "tautological."

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duction and exchange through different organizational arrangements, for example organizing distribution through franchising rather than through company-owned outlets. Political transaction costs "arise from the specific political institutions underlying political exchange in different polities" (North, 1990b: 364). Just as economic transaction costs rise with uncertainty, political transactions costs are the costs of striking unstable bargains under conditions of high uncertainty, where actors and interests are often obscure, there is no third-party enforcement, agreements are tacit and incomplete contracts, and outcomes can be abruptly overturned by the next election (Caballero and Arias, 2013; Caballero and Soto-Oñate, 2016). Political actors try to devise structures that aim to reduce these transaction costs and allow durable and enforceable bargains (for more details, see Chapter 7). Weingast and Marshall (1988) provides an example of this (Box 2.3).

Box 2.3 Political transaction costs

The concept of transaction cost has reached audiences far beyond economics, bridging the gap between different disciplines, particularly political science, where numerous contributions analyze the high transaction cost of reaching stable coalitions in highly imperfect political markets.

In a pioneering article, Weingast and Marshall (1988) examined the functioning of the US Congress through the lens of what they called "the new economics of organization." In this framing, public policies are the result of a series of bargains among various interests represented by legislators seeking reelection. Like economic transactions, political bargains have high transactions costs arising from imperfect information, opportunism, and the instability of political markets.

Weingast and Marshall assumed that congressmen represent heterogeneous groups of interests located within their districts, that political parties have limited capacities to constrain legislators, and that bills require a majority to be adopted. However, they differed from the prevailing view that legislators trade votes (or logrolling). The problem with treating legislative exchange of votes as similar to market exchange is that most "political" trades are not simultaneous. Today's legislation depends on future legislative events and expected benefits from legislation occurring in the future, raising problems of observability and

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the possibility that parties renege on agreements when circumstances change (ex post opportunism).

To circumvent the threat to durability and enforceability of bargains created by these political hazards, US legislators constructed alternative institutional solutions to vote trading. A key component was the committee system, which embedded the rights to control specific items of the political agenda. Operating under specific conditions (e.g., individual assignment to a limited number of seats, seniority system, bidding mechanism to assign vacant seats), this system facilitated enforcement of bargains. For example, members from farmers' districts sitting on agriculture committees and seeking farm benefits had to take into account and bargain with members of other committees, for instance members from urban districts sitting on welfare committees providing subsidies for food for the poor. In this institutional arrangement, sticking to the agreement so as to secure future bargains was a strong incentive to credibly commit.

Weingast and Marshall (1988) concluded that the institutional rules framing the action of these committees mitigated the "contractual problems" and allowed durable political coalitions.

The concept of political transaction costs is "built on the assumptions of costly information, of subjective models on the part of the actors to explain their environment and of imperfect enforcement of agreements" (North, 1990b: 355), allowing new institutionalists to escape the "a-institutional world of neoclassical theory." It thus complements the economic concept of transaction costs, opening the way to a more relevant analysis of those areas in which the two types of cost overlap. Recent illustrations can be found in Barzel (2000), North, Wallis and Weingast (2009), North et al. (2013), and Alston et al. (2018). Other important developments in NIE analysis of public policies and the nature and role of the state are discussed in Chapters 6 to 8.

2.4 Conclusions

The idea that transactions provide the basic unit of economic analysis is at the core of NIE. To new institutionalists, the economy is primarily about

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the transfer of usage rights, with the actual production and exchange of goods and services resulting from the nature and characteristics of these rights and the conditions of their transfer. Another key contribution is the demonstration that, whatever the type of rights at stake, there are different ways to organize these transfers, which entail different costs, called transaction costs. Identifying transaction costs and assessing their role in competing institutional arrangements provide the foundation to the modern economics of organization and institutions.

These ideas have stimulated a huge outpouring of research, yet there are still exciting opportunities for future study, particularly the need to better assess the comparative costs of integration versus alternative arrangements, to better identify and characterize the specific internal properties of various institutional settings and to embed these developments in more formalized models (Gibbons, 2010).

The concept of transaction costs has relevance far beyond the domain of economics. The contributions of the three founders of NIE, Coase, North, and Williamson, later joined by Elinor Ostrom (1990; 2005) have progressively influenced many other disciplines, from management to sociology, law, political science, and many others (Macher and Richman, 2008; Menard and Shirley, 2018; Medema, 2020). Indeed, transferring rights involves many different dimensions and might occur in many different contexts, such as political systems, public bureaucracies, and so on, which requires adaptation of the concepts to these different settings. Much of the earlier research on these issues has focused on mature democracies, but there is need for more analysis of non- and weak democracies.

There is important value-added in NIE's transactional approach. It has already thrown new light on the organization of economic activities at the micro-level and enlightened our understanding of the key role of institutions in shaping transaction costs and the role of transaction costs in shaping the way institutions work. It also has important implications for policy. Since the organization and costs of transactions matter, finding the appropriate match between institutional arrangements and the way rights are allocated revolutionizes the meaning of efficiency. As pointed out by Coase (1991 [2005]), in a world of positive transaction costs assigning rights to those who can use them most productively and reducing the institutional costs of transferring these rights are central to performance and, ultimately, growth and development.

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However, we must be cautious when using the concepts of transaction and transaction costs to explore new territories that we not transform them into "catch-all" concepts providing nothing more than *ex post* rationalization. The coming chapters substantiate the ideas introduced above, with appropriate cautions.

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3 Property rights

Property rights are among the most critical institutions in any society. Depending on how they are defined and enforced, they affect the scope for markets, firms, and other productive organizations; the extent of investment and innovation; and the losses from environmental degradation. Indeed, a crucial reason why institutions matter for economic performance is that they delineate and enforce property rights.

NIE's definition of property rights is dynamic and goes well beyond the legal definition (3.1). Private property rights are deeply intertwined with NIE's core concepts of transactions, incentives, and contracts, and are the focus of much of this chapter (3.2). The rise of impersonal institutions to define and defend private property rights is also a central issue, helping explain the rise of the modern state and economic development (3.3). Another key theme is the sources and outcomes of the many observed types of property rights – private, state, communal – as well as issues of open access. Elinor Ostrom's analysis of common pool governance among small, communal groups illustrates this range of institutional options (3.4). Notwithstanding this rich literature, there are many crucial unanswered questions (3.5).

3.1 Definition of property rights

Property rights have two meanings in economics: legal (or de jure) and economic (or de facto). New institutionalists have explored the formal institutions that define and enforce de jure rights (see e.g., Arruñada, 2003; Voigt, 2008; Voigt, Gutmann, and Field, 2015), and the informal institutions that constrain and support de facto rights (see, e.g., North and Thomas, 1973 [1999]; Ostrom, 1990; Greif, 2006).

3.1.1 Legal private property rights

Legal or formal property rights are assigned by the state and are "as old as human written records. From the Hammurabi code to the English

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common law the notion of legal ownership, or legal rights, to property is well defined" (Allen, 2000: 897). Legal rights have the advantage of third-party adjudication and enforcement (Barzel, 1989 [1997]), and are generally judged more secure than self-enforced or socially enforced rights. Both formal and informal property rights are credited with creating incentives to use resources in a more socially optimal way since owners internalize the benefits and costs of use (see Section 3.2). But there are other purported benefits to formal property rights, specifically: (1) they can be transferred at lower transaction costs to individuals motivated to use the resource most efficiently; (2) they reduce socially inefficient theft and conflict over insecure rights plus wasteful individual expenditures on protection (Trebilcock and Veel, 2008);[1] and (3) they are impersonal – they do not depend on who you are or your position in society – which is critical to the impersonal exchange underpinning modern society (North, 1990a; North, Wallis and Weingast, 2009).

3.1.2 Economic property rights

Economic property rights date from Alchian (1965: 818), who defined them as "the right to use goods (or to transfer that right)" so long as other property rights are not adversely affected. Legal rights are neither necessary nor sufficient for economic rights (Barzel, 2015: 719). They are not sufficient because you may have a legal right that is too costly to enforce (e.g., rights to a chunk of the Pacific Ocean) or norms may prevent exercising your rights, and not necessary because two owners can fully recognize and respect a boundary with a fuzzy legal basis and use the resource efficiently. Furthermore, some owners without legal rights may have de facto rights.

Studies suggest that formalizing informal rights increases owners' investment and the market values of assets. For example, Galiani and Schargrodsky (2010) found that legal title raised housing quality by 37 percent in a Buenos Aires slum, while Alston, Libecap and Mueller (1999) found that more secure titles increased land values by 36 percent in the Brazilian Amazon. Yet the picture is complicated. Sun and Ho (2016) cite case studies in Colombia, Mexico, Peru, and the US where legal titles did

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[1] See Coase (1960), Demsetz (1967) and Alchian and Demsetz (1973). Of course, society incurs costs for police, judges, etc. to protect private property rights.

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not improve housing quality, increase property values or reduce poverty.[2] Payne (2001), Gonzalez (2009), and Sun and Ho (2016) document cases where squatters transferred and inherited property without legal title because they had the sanction of their slum community. Moreover, Ensminger (1997: 168) studied cases in Africa where the cost of formalizing an informal or customary right was more than the benefits.[3] This unsettled debate is the subject of much research.

3.1.3 Types of property rights

Besides the distinction between legal and economic property rights, Alchian (1965; 1993) described three types of property rights: private, state, and communal. Private and state property rights are the exclusive authority to determine how a resource is used and to exclude other users. Communal property rights are rights that can be exercised within a defined group of citizens or group members. As we shall show, Ostrom found that communal rights often are effective, but only where some exclusion is possible. Some scholars add a fourth type, distinguishing between communal property, where resources are restricted to a community under agreed rules, and open access (Hardin, 1968), where resources are available to all takers (Merrill, 2002). Assets are in the public domain or open access because the cost of excluding other claimants exceeds their value, in some cases because the asset values are low, but in others because the transaction costs of securing property rights are so high. These divisions are not clear-cut and are complicated by the many facets of property rights, their use, and exchange. For example, a landowner may lease the right to till the land to another person, while a third person or the state owns the right to traverse the land (Alchian and Demsetz, 1973: 17). We discuss the four types at greater length in Section 3.4.

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[2] Under some circumstances the causality may be reversed: Razzaz (1993) found that squatters in Jordan invested to gain de facto property rights since they assumed that the state would be less likely to demolish completed houses.

[3] For additional studies of the sometimes adverse effects of converting informal to formal rights, see cites in Fitzpatrick (2005) and Trebilcock and Veel (2008).

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3.2 Why are property rights so central to NIE?

The economic definition of property rights has profound implications. As Coase (1991 [2005]: 37) put it:

> what are traded on the market are not, as is often supposed by economists, physical entities but the right to perform certain actions … it is obviously desirable that rights should be assigned to those who can use them most productively and with incentives that lead them to do so. It is also desirable that, to discover and maintain such a distribution of rights, the costs of their transference should be low … this can come about only if there is an appropriate system of property rights (and that the rights are enforced).

For all these reasons, property rights are vital to three central NIE issues: (1) incentives; (2) transactions; and (3) contracts and firms.

3.2.1 Incentives

Property rights are central to NIE because they define incentives for resource use, production, investment, and trade. Holders of private property rights are motivated to safeguard and improve their property, as we saw with titles in Buenos Aires and the Amazon. The more complete their rights – the more the power to exclude others, to control the flow of resources from the asset and to transfer the asset – the stronger the motivation. Where property rights are completely defined, owners have incentives to invest in and provide private goods because they capture the net returns from doing so. Where such rights and related private returns are not feasible, private actors will underinvest, such as in infrastructure, aspects of health care, and national defense. These services hence are social goods due to the nature of the property right, and their provision depends upon government action. Property rights can also convey monopoly power; for example, some argue that patents on improved seeds contributed to industry consolidation (Matson, Tang and Wynn, 2012) and a decline in investment in innovation (Schimmelpfennig, Pray and Brennan, 2003).[4] Moreover, because we live in a world of positive

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[4] Recently the open-source model (putting ideas in the public domain) has challenged the arguments that traditional property rights are needed to motivate innovation. Open-source innovators may be more strongly motivated by intrinsic motivations: signaling their skills, educating themselves, acting altruistically, etc. (Maurer and Scotchmer, 2006). (A large literature

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transaction costs, property rights are never entirely complete, while multiple owners dissipate the incentive effects. Incentive issues also loom when ownership and control are separate, as in large corporations, state-owned enterprises, and communal property.[5]

Another incentive issue arises because, in the absence of social or legal constraints, owners have little motivation to take into account the spill-over effects of their uses on others.[6] Coase called those spillovers social costs; most economists call them externalities. As we discussed in Chapter 1, Coase (1960) proposed that the affected parties might reach a bargain. Coase gives the example of a cattle raiser increasing the herd, which then damage a neighbor's crops. In the absence of legal liability, the cattle raiser might offer to rent the neighbor's parcel and keep it fallow or the farmer might agree to purchase fencing to keep out the roaming cattle. As we explore in Chapters 2 and 4, the feasibility of such contractual solutions depends on transaction costs as well as government regulation and legal precedents limiting owners' options. Multiple owners may not agree on solutions, an additional hurdle to bargaining. The transaction costs of bargaining are even higher for communal property, since no individual or sub-group of owners can exclude other users (Demsetz, 1967), although Ostrom described important exceptions (see Section 3.4).

3.2.2 Transactions

Transactions are about the transfer of rights to use a resource (see Chapter 2), which is central to the operation of a market economy. The more complete are property rights, the lower are transaction costs and the higher the gains from exchange (Allen, 2000: 898). This, combined with the incentive effects discussed above, explains why studies find stronger private property rights have beneficial economy-wide effects. For example, Acemoglu and Johnson (2005) find that income per capita and rates of investment are higher in countries where protection of property rights against expro-

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deals with intrinsic motivation; see cites in Frey, 2001; 2017; Bénabou and Tirole, 2003.)

[5] This issue in private corporations spawned a literature too extensive to cover here. See, for example, Berle and Means (1932); Arrow (1974); Chandler (1977); Fama and Jensen (1983).

[6] State ownership is often exempted from regulation and can be a major source of externalities as with, for example, rampant pollution at US military bases (Hamilton, 2016).

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priation or confiscation of returns by politicians and elites is stronger.[7] In a less formal treatment, North and Thomas (1973 [1999]) attribute the rising prosperity and productivity in Europe in the Middle Ages to increasingly stronger measures to protect property rights.[8]

Property rights affect not only the size of the economic pie, but also its distribution. North, Wallis and Weingast (2009) describe how elites in most societies except modern democracies restrict access to secure property rights solely to members of the dominant coalition. More inclusive property rights allow transfer of assets to owners who would use them more effectively, increasing returns and opportunities for exchange (see Box 3.1 on the experience of Poland and Ukraine).

Box 3.1 The history of property rights in Poland and Ukraine[9]

Poland and Ukraine have been economically and politically intertwined for over 650 years. Yet they diverged remarkably after the fall of communism in 1989 in Poland and in 1991 in Ukraine, despite very similar initial conditions (GDP per capita, urbanization and industrialization, infant mortality rates, etc.). Since its transition, Poland has grown rapidly, joined the European Union (EU) and the Organisation for Economic Co-operation and Development (OECD), and become an economic success story, while Ukraine has seen economic declines and two revolutions.[10] Despite “sharing a border, a similar language (mutually intelligible if spoken slowly), a long history of overlapping experiences and institutions and even substantially the same political institutional make-up post-1989, the two countries have emphatically *not* shared the same experience of property rights” (Hartwell, 2017: 143, emphasis in original).

Poland developed broad-based property rights defended by informal, small-scale institutions (such as village courts). “As early as 1348, ‘a peasant … had full rights of ownership of movable property, and in

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[7] See also Knack and Keefer (1995); Rodrik, Subramanian and Trebbi (2004).

[8] See also de Long and Shleifer (1993).

[9] Drawn from Hartwell (2017).

[10] Poland also benefitted from support from the EU and access to the common market.

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some cases, he could buy, sell, and bequeath land'" (Kamiński, 1975: 267 quoted in Hartwell, 2017: 146). This tradition survived partitions, occupations, setbacks and the transition from communism. It was formalized through laws protecting private property rights and an independent judiciary. In contrast, Ukraine was never able to cultivate such diffusion of political power or broad-based property rights. During the transition, power stayed centralized in the communist dominated Parliament. Property rights remained insecure with episodes of land grabs, business expropriations, and a 19-year "temporary" moratorium on land sales.

> Recent events in Poland, including a move by the ruling party to politicize the Constitutional Court, shows that even established property rights may be tenuous in the face of concerted political opposition. In fact, the key lesson from history in both Ukraine and Poland is that diffusion of power can protect property rights, but … the protection of both legal and economic property rights is a constant struggle … (Hartwell, 2017: 156)

3.2.3 Contracts and firms

Property rights are central to another NIE preoccupation: contracts and firms. Coase (1960) and later Cheung (1983) described the firm's productive inputs as property rights. Following Coase, Cheung contended that the owner of a factor of production has the choice of "(1) producing and marketing goods himself, (2) selling his input outright [on the market], or (3) entering into a contractual arrangement surrendering the use of his input to an agent in exchange for an income" (1983: 3). As we know from Coase (1937), the owner's choice will attempt to economize on transaction costs (more on this in Chapter 5).

Labor is a special type of input, since human beings are not robots. Workers have discretion and information about their effort that supervisors lack which makes it costly to monitor effort (Alchian and Demsetz, 1973). Ways to address this information asymmetry through monetary and non-monetary incentives is the subject of a large literature,[11] including agency theory (see Chapter 1) and analyses of different contractual forms (such as wage labor, share cropping, and fixed rent in agriculture; see, e.g., Cheung, 1969b; Alston and Higgs, 1982; Allen and Lueck, 2003).

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[11] For an overview, see Miller (1992).

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3.3 Institutions to define and enforce property rights

Throughout history, humans have devised creative ways to secure property rights that can be characterized as (1) informal and personal (such as a handshake); (2) semi-formal and semi-personal (such as community enforcement); and (3) formal and impersonal (such as written contracts and laws). The development of formal property rights enforced by courts and legal sanctions was a major innovation, even though informal and semi-formal mechanisms still predominate in contemporary economies (Macaulay, 1963). NIE has been preoccupied with the emergence of these formal institutions; see, for example, North and Thomas (1973 [1999], Greif (2006), North, Wallis and Weingast (2009).

3.3.1 Informal, personal

North, Wallis and Weingast (2009) argue that powerful elites used coercion, formed coalitions, made deals and eventually built governments to protect their property rights, not out of the goodness of their hearts, but because their rents were higher under social order than under endemic civil wars. Elites used the state to assure their domination of exchange by limiting non-elite access to markets or power. “Thus, property rights and legal systems have their origins in the definition of elite rights” (Shirley, 2008: 43).

In eras when information was scarce (and in similar circumstances today), merchants protected their property rights by transacting only with people whose reputation they or people they trusted knew. But relying solely on reputation limits transactions to personal exchanges. Social networks, such as religious, kinship or ethnic groups, extend exchange over wider circles and longer distances because network members can share their knowledge about reputations and enforce agreements by threatening to expel cheaters (North and Thomas, 1973 [1999]; North, 1990a; Greif, 1993). For example, Box 1.2 summarizes Greif’s (1993) analysis of how Jewish Maghrebi traders during the Middle Ages used their common religion, ethnicity, language, and social ties to set up informal institutions to exchange information about which agents were trustworthy. Such networks expand trade beyond face-to-face exchange, but transactions are still restricted to members and require prior information on personal attributes. Nevertheless, Bernstein (2019) finds that such “small-world

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networks" have contract enforcement properties that effectively support trade among large numbers of traders at considerable distances in many modern industries.

3.3.2 Semi-formal, semi-personal

During the twelfth and thirteenth centuries, the "community responsibility system" allowed impersonal transactions across jurisdictions and over more than the lifespan of the individual merchant, according to Greif (2006). Semi-autonomous towns and cities or communes in Europe would stand behind the trustworthiness of their members when they travelled to markets (such as the annual Champagne fairs). If a commune member defaulted on a contract, the entire commune was legally liable and had to pay compensation or forfeit trading with that market (Greif, 2006). "By providing a way to enforce contracts with unknown merchants who were not part of any local social network but who were known in their home communities, commune enforcement was an intermediary between social enforcement and state enforcement, but it fell apart as towns grew and it became easier for cheats to pretend to be members of a commune" (Shirley, 2008: 27). Guilds, business associations, and the like similarly regulated members' behavior and had similar disadvantages. At a time when information was scarce and costly, it was difficult to add new members so transactions continued to be restricted to relatively narrow groups. Yet today, with information plentiful, these sorts of associations and groups continue to be important. For example, the New York Diamond Dealers Club signals and monitors reputations since members agree to submit all disputes to an arbitration board that has the power to fine, suspend, and expel members (Bernstein, 1992). Such associations are key to a secretive industry where "a handshake accompanied by the words *mazel u'broche* creates a binding agreement" for the exchange of millions of dollars in diamonds (Bernstein, 1992: 121). (See McMillan and Woodruff, 2000 for additional examples.)

3.3.3 Formal, impersonal

In Europe during the sixteenth and seventeenth centuries, the rules and customs of merchants were codified into the so-called Law Merchant enforced by town and city courts, the nobility or kings (North and Thomas, 1973 [1999]). North and Weingast (1989) describe how after the "Glorious Revolution" in England in 1688, the king could no longer arbi-

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trarily issue monopolies, while the common law courts and Parliament, which were more favorable to property rights, became independent of the monarchy (see also Chapter 6). The effect was “a marked increase in the security of property rights” (North and Weingast, 1989: 804). There were other innovations as well; for example, Parliament issued patents. Previously, intellectual property was either not protected at all, requiring inventors to rely on secrecy, or protected through a monopoly subject to royal whims (North and Thomas, 1973 [1999]: 148–9).[12]

There are risks from relying on the law and courts, however. What stops the ruling faction from using government’s power to confiscate the gains from exchange or even the property itself through quasi-legal means (such as confiscatory taxes)? The development of institutions to constrain the government from abusing its power contributed to the emergence of the modern state, as we discuss in detail in Chapter 6.

3.3.4 Public and private ordering

The development of property rights enforced by the government was a major innovation. However, legal rights are not usually embodied in laws but delineated in contracts (Barzel, 1989 [1997]). Moreover, property rights are predominately protected, not by resort to laws and the legal system (what Williamson termed “public ordering”), but through safeguards against opportunistic behavior built by the parties to the contract (“private ordering”).

Private ordering affects the design of contracts and firms: the contractual parties will “realign incentives and embed transactions in a protective governance structure” to mitigate the contractual problems that would otherwise arise (Williamson, 2002: 438). We consider the issues around contracts in detail in Chapter 4.

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[12] Today, intellectual property rights cover increasingly intangible but valuable assets and are sometimes used in ways that deter innovation, as when patent holders buy and kill rival inventions. Hahn (2003) surveyed the literature on the effects of patents and found it “inconclusive” on whether stronger patents increase or decrease innovation (2). He concluded that “institutional factors ranging from the structure of research institutions to seemingly tangential laws appear to play a critical role in how patent policy gets translated into innovation and R&D” (39).

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Public ordering is nevertheless vital:

> recourse to reliable courts for purposes of ultimate appeal, should private ordering efforts to resolve conflicts break down … reduces contractual risks that would otherwise deter exchange. Economies with better rules of the game will thus be able to support more complex and potentially hazardous interfirm transactions than will economies with less developed rules and/or less-reliable enforcement, ceteris paribus. (Williamson, 2002: 440 n2).[13]

Box 3.2 gives an example of how complexity affects the tradeoff between public and private ordering.

Box 3.2 Private vs. public ordering in California's and Nevada's mines[14]

Mining in California and Nevada illustrates the importance of public ordering for complex transactions (Anderson and Hill, 2004: ch. 6). After gold was discovered in California in 1848, private ordering created well-defined and enforced property rights that were exchanged through contracts. Despite some violence, miners generally adhered to such cultural norms as the principle of first possession, justice through majority rule, and trial by jury. With statehood, the private ordering was codified in California's 1851 law (the Civil Practices Act) and courts recognized the camps' "customs, usages and regulations" (114). In 1866 the Federal Government further formalized many of the local rules created through the mining camps' private ordering.

Initially, property rights over the gold and silver discovered in Nevada in 1850 were also enforced through private ordering. However, Nevada's major deposits were in deep veins, leading to numerous disputes over surface versus subsurface rights, boundaries between veins, and rights to follow veins branching off main veins, creating pressures for more formal and permanent arrangements. Because of the complexity of establishing property rights to Nevada's rich underground veins and the large returns to specialization in definition and enforcement of property rights, Nevada moved quickly to public ordering through the enactment of 178 statutes and a number of state Supreme Court verdicts.

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[13] See also Arruñada (2012a).

[14] Based on Anderson and Hill (2004: ch. 6).

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Libecap (1978) shows statistically that Nevada's increased specificity of property rights was related to rising resource values and potential for conflict.

Thus far we have largely focused on private property rights, but the other types also present important issues for NIE research.

3.4 Private, state, communal, and absent property rights

We mentioned that property rights can be (1) private, (2) state, (3) communal (no member of a loosely defined community can exclude any other member), or (4) absent (open access, that is, in the public domain).

3.4.1 Private

We have been discussing private property rights as though they were static, but in reality, they are in flux because the costs of defining and enforcing property rights vary over time, across different institutional and economic settings, and with changes in technology. For example, although many farmers had legal title to their land in the Western US, their rights were not enforceable until the invention of barbed wire greatly reduced the cost of fencing to exclude grazing cattle (Anderson and Hill, 2004). The benefits of claiming property rights also fluctuate as asset values rise and fall with changes in technology, markets, and institutions (Barzel, 1989 [1997]). Individuals are constantly scrambling to buy, trade or steal property rights, and attempting to privatize rights in the public domain.

Given the constant vying for property rights, it is not surprising that they are sometimes the subject of prolonged conflict. Weak state institutions feed such conflict. For example, Alston, Libecap and Mueller (1999) describe how the government of Brazil adopted a policy of land redistribution but failed to provide enough resources, resulting in a woefully slow process. Landless peasants seized land, purposely designing their invasions to pressure the land reform agency and politicians to prioritize their demands for land redistribution. Landlords in turn appealed to local courts that typically evicted the squatters, resulting in a cycle of

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